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February 29, 2000

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Mr. Vernon A. Williams
Secretary
Surface Transportation Board
Office of the Secretary
Case Control Unit
Attention: STB Ex Parte No. 582
1925 K Street, N.W.
Washington, D.C. 20423-0001

ENTERED Office of the Secretary
FEB 29 2000
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Dear Mr. Williams,

In accordance with the February 16, 2000 decision of the Surface Transportation Board (the Board) in STB Ex Parte No. 582, attached please find a summary of the statement that Mercer Management Consulting, Inc. (Mercer) will present at the public hearing to be held on March 9, 2000.

We appreciate the opportunity to submit this summary of our statement, and look forward to appearing before the Board on March 9.

Respectfully yours,

Hugh L. Randall
Vice President

William C. Harsh, Jr.
Vice President

BEFORE THE

SURFACE TRANSPORTATION BOARD

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PUBLIC VIEWS ON MAJOR RAIL CONSOLIDATIONS

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SUMMARY OF STATEMENT

OF

HUGH L. RANDALL, VICE PRESIDENT

AND

WILLIAM C. HARSH, JR., VICE PRESIDENT

OF

MERCER MANAGEMENT CONSULTING, INC.

February 29, 2000

Summary of Statement of Hugh L. Randall and William C. Harsh, Jr.

Introduction

This summary of the statement of Hugh L. Randall and William C. Harsh, Jr. represents the views and opinions of Mercer Management Consulting, Inc. (Mercer) with respect to major railroad consolidations and the future structure of the North American railroad industry. Mr. Randall is a vice president and director of Mercer and directs the firm's global Transportation Group. Mr. Harsh is a vice president in Mercer's Transportation Group. Both Mr. Randall and Mr. Harsh have many years of experience consulting to railroads in the United States and throughout the world.

Mercer Management Consulting, Inc. (Mercer) maintains one of the largest transportation consulting practices in the world. Mercer has not only provided strategic, operational, and management consulting advice to virtually every Class I railroad in North America, but it has also acted as the primary advisor to numerous countries and railroads throughout the world to assist them with their railroad restructuring efforts. This global perspective has given Mercer an opportunity over the last 25 years to observe patterns and trends in the structuring of the railroad industry, and to develop insights into the business strategies which have succeeded – and failed – within the industry.

Mercer's statement will be organized in accordance with the four questions posed by the Board in its January 24, 2000 decision in this proceeding. In that decision, the Board asked for views concerning:

1. Whether the proposed merger of Burlington Northern Santa Fe and Canadian National (BNSF/CN) would lead to significant additional consolidation in the railroad industry

2. The timing of this potential consolidation

3. The effect of railroad consolidations on the financial condition of the railroad industry

4. Whether the railroad industry has and will have the necessary infrastructure, capacity, and configuration to meet expected demand for freight service now and in the future

This document summarizes Mercer's views with respect to those matters.

I. The Prospect for Further Consolidation

In its January 24, 2000 decision, the Board noted that there has been speculation that the strategic responses of the remaining North American rail carriers to the proposed BNSF/CN merger will lead to a new round of major railroad consolidations, ultimately resulting in the formation of two North American transcontinental railroad systems.

Mercer does not believe that significant further consolidation within the North American railroad industry necessarily will occur immediately, if at all.

We believe that successful business endeavors respond to the evolving needs of a company's customers. In the case of BNSF and CN, the managements of these two railroads have concluded that they can meet an unmet customer need for efficient and integrated north-south railroad service. This need arises from the continuing integration of the North American economies brought about by the North American Free Trade Agreement (NAFTA). To meet this need, BNSF and CN have proposed to create a holding company that will coordinate the service provided by their respective companies in order to serve north-south traffic flows more efficiently.

Historically, some railroads have responded to a merger among competitors by engaging in further mergers. In cases where responsive mergers are based upon the demands of the railroads' customers, and thus seek to create benefits similar to those that will be enjoyed by the customers of a competitive merged railroad, such mergers can make business sense.

For instance, customers located on the Union Pacific (UP) and Canadian Pacific (CP) may demand more efficient and cost-effective north-south service to compete with the service provided by a merged BNSF/CN system. If this is the case, then it may make business sense for the managements of UP and CP to explore a merger or some other arrangement that would satisfy their customers' demand for competitive service.

However, in cases where responsive mergers are not based upon customer demand, they do not make business sense and, we believe, should not occur. Specifically, we are not aware of any significant customer demand for consolidating the major eastern and western railroads in the United States at this time. We expect that this proceeding will reveal a present lack of demand for such a transcontinental United States duopoly system.

II. The Timing of the Potential Consolidation

We are aware of the fatigue that some railroads and their customers are expressing as a result of the difficulties encountered after two recent railroad consolidations. However, BNSF and CN have not had such problems, and are thus free to focus on meeting the next level of customer requirements. In this context, we believe that the need to respond to market and customer demands requires the managements of BNSF and CN to proceed with consolidation of the two railroads.

It is well known that markets wait for no one. We live in a rapidly globalizing world economy, and the North American marketplace created by NAFTA is developing very quickly. Railroad customers participating in this marketplace need efficient transportation, and if the railroads cannot supply this want, customers will buy their transportation from other, more efficient providers.

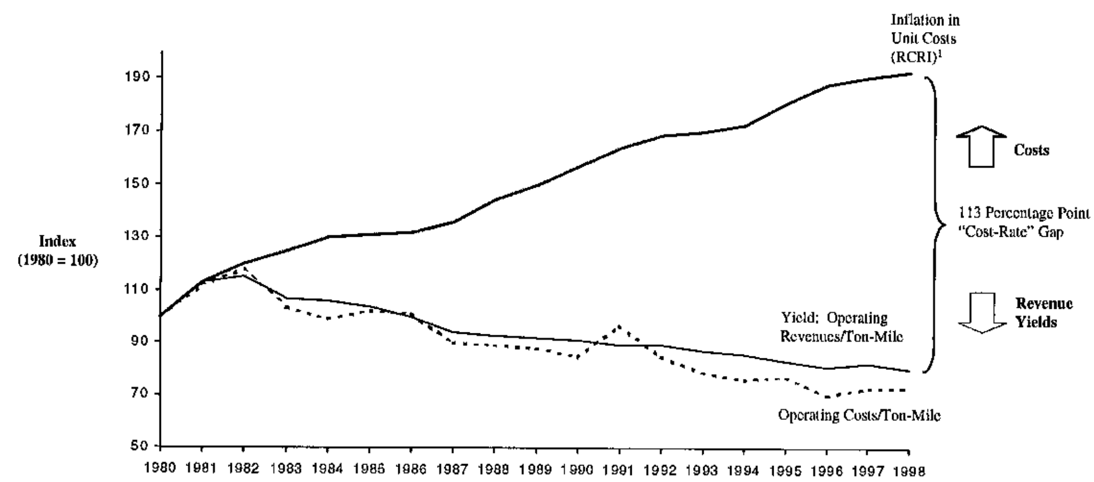
As a principal advisor to the Government of Mexico, Mercer knows that this was the Government's primary motivation in privatizing its railroad network. Mexico realized that its railroads would have to prepare quickly to compete in the rapidly developing NAFTA environment. Otherwise, they would be left behind to wither.

BNSF and CN face similar competitive imperatives. Mercer is aware, through our role as advisor to many carrier and financial participants in the transportation marketplace worldwide, that many competitors – including non-traditional competitors such as European freight forwarders – are actively developing strategies to handle NAFTA transportation flows. Already, truckers are developing substantial north-south flows of heavy commodities – including grain, fertilizer, plastic pellets, steel, and lumber – across the border between Canada and the United States. Not only are these commodities at the heart of the railroads' core business, but many of the shipments are developing in lanes more than 500 miles long where railroads historically have enjoyed a competitive advantage. North American railroads cannot afford to sit still while these competitors develop their systems. If they do – or are forced to – they may well find that these markets are lost to them.

III. Financial Condition of the Industry

Railroad managements are under enormous competitive pressure to find new productivity gains each year. As the following exhibit illustrates, railroads have faced a "cost-rate gap" caused by declining yields (revenue per ton-mile hauled) and increasing input costs (the cost of a gallon of fuel, an hour of labor, etc.) for the past two decades. They have survived in this environment each year only by finding new sources of productivity. Many of these efficiencies have come from increased scale and the opportunity to consolidate functions following mergers. In most years these efficiencies – including the efficiencies made possible by mergers – have created sufficient productivity gains to bring railroads' cost per ton-mile below their revenue per ton-mile. This produces an operating income and enables the rail industry to survive.

"Cost-Rate Gap"
Average Revenues and Unit Costs
(1980-1998)



Source: *Railroad Facts, 1999 Edition*, Association of American Railroads; Mercer analysis.
[1]Railroad Cost Recovery Index.

Shippers, however, are the major beneficiaries of this process. As the exhibit also shows, most of the productivity gains achieved by the railroads have been passed through to their customers in the form of lower rates. This has not been done voluntarily, but rather as the result of intense intramodal and intermodal competition. As input costs continue to increase, railroad managers must now find new sources of productivity. Most of the low-hanging fruit, however, has long since been harvested. Thus, restricting railroad managers' access to any significant source of productivity improvements – including mergers – will work to the detriment of the financial health of the industry.

IV. Industry Capacity

The capacity of a railroad system is dependent upon the capacity of the subsystems that make up the transportation functions of a railroad. These include:

- The physical facilities, including track, signals, interlocking plants, classification facilities, terminals, servicing and fueling facilities and, in some cases, power distribution systems

- Equipment, including cars and locomotives

- Crews, which must be available to operate trains and which operate subject to restrictions created by regulations and labor agreements
- Operating practices such as (a) policies on train size, speed, and power, (b) train priorities, (c) train scheduling, (d) blocking and classification practices for marshalling trains, and (e) maintenance policies.

Although extensive studies of the theoretical capacity of railroad systems have been conducted, the practical capacity of these systems is often quite different. This is due to seasonal, day of week, and even hourly traffic variations; requirements to give some traffic priority; unexpected events such as storms, derailments, and human error; and scheduled and unscheduled maintenance.

While most of the railroad network in North America presently has sufficient capacity to handle current and (reasonable) projected traffic flows, choke points do exist today and will inevitably emerge at other places in the system if the industry is successful in attracting new traffic. Choke points can be addressed both by creating additional design capacity and by reducing the gap between design and practical capacity. The former can require substantial capital, while the latter generally does not.

Creating additional design capacity involves such actions as building additional main tracks; lengthening existing sidings and building new sidings; spacing signals more closely; increasing train speeds by improving track structure; expanding yard and terminal facilities; and, in extreme cases, rebuilding previously abandoned or downgraded lines. Moving practical capacity closer to theoretical limits involves such actions as changing operational practices; investing in systems required to manage the complex relationship between individual train schedules in a network; and improving maintenance procedures to reduce derailments.

We believe that the railroads are addressing the choke points that presently exist. Provided that they operate in a regulatory and commercial environment that permits them to continue to attract sufficient capital and skilled management, we see no reason for them not to continue to address choke points as they develop.

Conclusion

In conclusion, we believe that the state of the railroad industry is quite typical of industries in today's rapidly changing business environment. Managements are seeking to identify emerging and evolving customer needs, and to develop strategies to meet them. They are doing this in a globalized competitive environment in which their customers must compete in new markets worldwide, non-traditional competitors are emerging from all directions, and timing is critical.

They are coping with the challenges created as intense competition drives down prices at the same time input costs rise. And they are struggling to build capacity for the future while at the same time addressing choke points that develop in the present system. The actions taken by managements to address all of these challenges often create short-term market dislocations and can cause well-publicized problems. But we believe that few would dispute that the net effect of the process is to create an ever-more efficient and competitive economy. We believe that this conclusion clearly applies to the railroad industry in North America.